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Discounts for Co-ownership Interests

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Discounts for Co-ownership Interests

-by Neil E. Harl*

Over the last 30 years, substantial changes have emerged over the taxation of co-owned assets (other than joint tenancy).¹ Interests in real property held as community property have been eligible for a discount in value for unmarketability of the decedent's fractional interest, at least since 1982.² However, discounts for undivided interests in tenancy-in-common ownership of property otherwise were rejected until fairly recently.³

A major shift in discounting

However, that changed dramatically beginning in 1989 in a Tax Court decision from Illinois (which at the time had relatively "tough" rules for partition and sale).⁴ In that 1989 Tax Court decision, the court allowed a discount of 12.5 percent for tenancy in common ownership.⁵ That opened the flood gates for discounting tenancy-in-common ownership interests with the percentage of discounting increasing rapidly to the 20 percent level, with some discounts even higher.⁶

One court decision, *Bonner v. United States*,⁷ went so far as to allow discounts of undivided interests at the husband's death of ranchland and other property held under a QTIP trust even though the post-death ownership may be reunited in the same beneficiaries. While the Fifth Circuit found that acceptable and followed *Estate of Bright v. United States*⁸ which was followed by *Propstra v. United States*,⁹ the Seventh Circuit Court of Appeals in *Citizens Bank and Trust Co. v. Commissioner*¹⁰ criticized *Estate of Bright* which put the damper on the *Bonner* decision.

In all of this, the Internal Revenue Service has insisted that discounting should be limited to the cost of partitioning the property.¹¹ However, in 2005, the Fifth Circuit Court of Appeals awarded litigation costs on the grounds that the IRS position of limiting co-ownership discounts to costs of partitioning was not justified.¹²

Avoiding plans to talk about selling the property if discounting is contemplated

A pair of court decisions, decided several days apart and within 50 miles of each other, illustrate the importance of advising the family that talk about the likelihood of selling the property can prove a barrier to discounting or at least reducing the discount. In the case of *Estate of Brocato v. Commissioner*¹³ a 20 percent fractional share discount was allowed for apartment houses in the City of San Francisco. Two weeks later,

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in *Estate of Busch v. Commissioner*,¹⁴ the Tax Court allowed a 10 percent discount in a decision involving two elderly family members who owned farmland within a city east of San Francisco. The court stated that a 10 percent discount was “more than adequate” to cover reasonable costs of marketing for fractional interests and of partitioning if it came to that. The estate had claimed a 40 percent discount which the Tax Court knocked down to 10 percent. The view of the court was obviously shaped by widespread talk about the likelihood of sale of the property inasmuch as it was surrounded by developed areas and was ripe itself for development. The lesson from that case is “. . . if you anticipate trying to obtain a discount, **don’t utter a word about sale.**”

Discounts for art collections

Until recently, discounts for art collections were relatively modest, around five percent.¹⁵ However, in a 2013 decision in the Fifth Circuit Court of Appeals, *Estate of Elkins v. Commissioner*,¹⁶ the appellate court allowed a 44.75 percent discount for an undivided interest for a lengthy list of art works owned in co-ownership by the decedent, ostensibly because the decedent’s children would likely purchase any fractional interest sold. The Internal Revenue Service had argued in that case that no discount should be allowed from the *pro rata* fair market value of the decedent’s interest. However, the appellate court was impressed by the taxpayers’ argument that there is no “recognized” market for fractional interests in art and the art in question had been voluntarily subjected to restraints on partition (and alienation) as well as restraints on possession.

Will the Fifth Circuit Court of Appeals in *Elkins v. Commissioner*,¹⁷ chart the course for art collections going forward? The Fifth Circuit Court of Appeals has earned the distinction of being the “most taxpayer friendly” circuit court in the country. But it will require additional cases before it can be said that the view in *Elkins* will prevail widely.

END NOTES

¹ See 5 Harl, *Agricultural Law* § 43[02[1][c] (2017).

² Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

³ See *Estate of Pudim v. Comm’r*, T.C. Memo. 1982-606; *Estate of Clapp v. Comm’r*, T.C. Memo. 1983-721; *Estate of McMullen v. Comm’r*, T.C. Memo. 1988-500 (value of decedent’s undivided interest in trust property could not be discounted as fractional share where trust property to be sold as entire fee simple interest).

⁴ See *Youle v. Comm’r*, T.C. Memo. 1989-138.

⁵ *Id.*

⁶ E.g. *Estate of Cervin v. Comm’r*, T.C. Memo. 1994-550, *reversed on another issue*, 111 F.3d 1252, (5th Cir. 1997) (20 percent discount allowed for a 50 percent interest in farm and homestead). See *Estate of Wildman v. Comm’r*, T.C. Memo. 1989-667 (decedent’s 20 percent interest in farmland discounted a total of 40 percent for a minority interest and for restrictions on transferability).

⁷ 84 F.3d 196 (5th Cir. 1996).

⁸ 658 F.2d 999 (5th Cir. 1981).

⁹ 680 F.2d 1248 (9th Cir. 1982).

¹⁰ 839 F.2d 1249 (7th Cir. 1988) (voting and non-voting stock placed in separate trusts).

¹¹ See Ltr Rul. 9336002, May 28, 1993); Ltr. Rul. 9943003, June 7, 1999 (discount is a matter fact).

¹² *Estate of Baird v. Comm’r*, 416 F.3d 442 (5th Cir. 2005).

¹³ T.C. Memo. 1999-424.

¹⁴ T.C. Memo. 2000-3.

¹⁵ E.g., *Stone v. United States*, 2007-2 U.S. Tax Cas. (CCH) ¶ 60,545 (N.D. Calif. 2007), *aff’d*, 2009-1 U.S. Tax Cas. (CCH) ¶ 60,572 (9th Cir. 2009).

¹⁶ 2014-2 U.S. Tax Cas. (CCH) ¶ 60,683 (5th Cir. 2014).

¹⁷ 2014-2 U.S. Tax Cas. (CCH) ¶ 60,683 (5th Cir. 2014).

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